**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

CC:LM:FSH:MAN:2:TL-N-6037-00, 6038-00
VATaverna

date:

to: Paul Rinaldi
Territory Manager (MCT)
Attn: Revenue Agent Tony Stulich (Group 1646)

from: Area Counsel (Financial Services)

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subject: [redacted]
**Refunding Credits**

**UIL Nos. 832.00-00, 832.05-00, 832.14-01**

This memorandum responds to your request for assistance dated October 19, 2000. This memorandum should not be cited as precedent. Specifically you have requested that we assist you in analyzing [redacted]'s ("[redacted]") method of accounting for refunding credits during the [redacted] and [redacted] taxable years pursuant to I.R.C. § 832.

Issue

Whether [redacted] properly accounted for refunding credits during its [redacted] and [redacted] taxable years, pursuant to I.R.C. § 832.

Facts

[redacted], the principal operating subsidiary of [redacted], is engaged in the insurance business. It specializes in issuing financial guaranty insurance on municipal bonds. Municipal bonds comprise bonds, notes, and other evidences of indebtedness issued by states, municipalities, and other governmental authorities, instrumentalities, and agencies. The premiums paid for financial guaranty insurance are generally paid by municipalities out of bond proceeds. The municipalities are exempt from Federal income tax.

Financial guaranty insurance provides an unconditional and irrevocable guarantee of a bond issuer's obligation to pay principal and interest on the insured bonds when due. The policies issued by [redacted] provide that in the event of a bond issuer's default, [redacted] will pay principal and interest to the bondholders as originally scheduled for the issue's remaining term or until the issuer can resume the payments on its own. [redacted] insurance enhances the credit quality of municipal bond issues. Securities insured by [redacted] receive a higher credit rating than otherwise, resulting in interest cost savings.

[redacted] is regulated by the state insurance departments in the states in which it conducts business, including the State of New York. It is required to file with state regulators an Annual Statement on a form prescribed by the National Association of Insurance Commissioners ("NAIC"). On its Annual Statements, [redacted] is required to report, inter alia, earned and unearned premiums.

Under a typical financial guaranty insurance contract issued by [redacted], a single premium is received by [redacted] at the time the contract is issued and is included in its gross premiums. The amount of the premium is based on the assumption that the insurance will remain in force until maturity of the insured bond. Every policy issued by [redacted] during the years in issue provided that:

> This policy is noncancelable. The premium on this policy is not refundable for any reason, including payment of the Bonds prior to maturity.

Although the insurance premiums are paid in full at the time the insurance policy is issued, [redacted] earns them pro rata over the period of risk. Premiums are allocated to each bond maturity based on principal and interest due on each bond and are earned on a straight line basis over the term of each maturity. Accordingly, the portion of net premiums earned on each policy in any given year represents a relatively small percentage of the total net premiums received when a policy is first written. The balance represents unearned premiums to be earned in the future over the remaining life of the bond.

Municipal bonds may be issued with provisions that permit a call or defeasance[1] prior to the stated maturity date. In such a case, a refunding bond may be issued to fund the call or defeasance. When the insured "Obligations" are called, the policy insuring the "Obligations" has expired. When the old

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[1] When an issuer calls a bond, it pays the outstanding principal amount in full and extinguishes the bond. A defeasance occurs when a bond issuer secures the payment of principal and interest due over the life of the bond by purchasing a sufficient amount of securities (typically U.S. Treasury notes) to pay the principal and interest on the bond and places the securities in escrow.

issue is refunded, [redacted]'s liability for payment of the bonds insured by the old policy ends. Although, [redacted] was not obligated under the written terms of its insurance contracts to refund any portion of the remaining unearned premium in the event an issuer called or defeased an insured bond issue, [redacted] generally issued refunding credits to the municipality against the premium on the new policy.

At sale, when the final debt service schedule was known, [redacted] forwarded a commitment letter to the bond issuer or underwriter, quoting a premium dollar amount applying the premium rate to the total debt service associated with the insured bond.

[redacted] made the following accounting entries on its books and records with respect to refunding credits. When it initially wrote a contract for a new money issue, it credited premiums written and debited cash or accounts receivable. [redacted] also credited the balance sheet for 100 percent of the written premium as an unearned premium reserve and debited the income statement for the same amount to reflect the unearned premium change.

When a refunding insurance contract was to be issued and a refunding credit agreed upon, [redacted] reflected these items with the following statutory accounting entries:

1. It debited unearned premiums for the remaining unearned premiums;

2. It debited premiums written to the extent a refunding credit was given to reduce the premiums anticipated on the old policy and credited accounts receivable for the same amount; and,

3. Simultaneously, it debited accounts receivable for the refunding credit as well as the additional cash premium and credited premiums written for both the refunding credit and the cash premium to reflect the gross premiums received on the new refunding contract.

Then, just as it did with the premium received on a new money issue contract, [redacted] credited one hundred percent (100%) of the gross premium (both the cash and the refunding credit) received on the refunding insurance contract to the balance sheet as unearned premium and debited the same amount to the income statement to reflect the unearned premium change attributable to the refunding insurance contract. The new unearned premium amount would be earned over the coverage period of the refunding insurance contract.

Discussion

[redacted], as a financial guaranty insurance company, must compute its taxable income under section 832. See I.R.C. § 831. Taxable income equals gross income less allowable deductions. I.R.C. § 832(a). Underwriting income means "the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred." I.R.C. § 832(b)(3). Section 832(b)(4) provides that "premiums earned on insurance contracts during the taxable year" is computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the amount determined in (A), add 90 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 90 percent of the unearned premiums on outstanding business at the end of the taxable year.

(C) To the amount so determined, in the case of a taxable year beginning after December 31, 1986, and before January 1, 1993, add an amount equal to 3 1/3 percent of unearned premiums on outstanding business at the end of the most recent taxable year beginning before January 1, 1987.

The only dispute between the parties involves the tax consequences of [redacted]'s practice of adding part of the unearned premium from the refunded bond, referred to by [redacted] as a "refunding credit," to the unearned premium for the refunding bond and treating the entire amount as "outstanding business" at the end of the taxable year of the refunding.[2]

The same issue was present in a case involving another taxpayer ("Taxpayer X"). After extensive pre-trial discovery and consultation with the National Office, it was determined that the Taxpayer X case should be conceded based upon the facts of the case. In the instant case, the facts that have been developed during the audit are substantially identical to the facts that were present in the case of Taxpayer X. Accordingly, the refunding credit adjustment in this case should, likewise, be

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[2] [redacted] contends that the practice of offering a refunding credit allows them to remain competitive. We do not question the business purpose of the credits, but that purpose is not material in determining the federal income tax consequences that occur when the contract insuring the refunded bond terminates.

conceded.

In a TAM (9823004) dated February 23, 1998, the National Office addressed Taxpayer X's method of computing premiums earned under section 832(b)(4). Focusing on the no-refund clause contained in the policies issued by that financial guaranty insurance company, the TAM concluded that when an insurance contract or policy expires, all of the remaining unearned premium must be taken into income. According to the TAM, once a policy is terminated upon the call or defeasance of an insured bond, the policy can no longer be viewed as outstanding business and the remaining unearned premium associated with the terminated policy must be recognized as income under section 832(b)(4). In support of this argument, the National Office relied on:

i) the NAIC rules governing accounting practices for purposes of completing the NAIC Annual Statement which provide that when an insurance contract or policy expires, the entire premium has been earned; and

ii) the no-refund language contained in the insurance policies.

Taxpayer X took the position that in situations in which it applied a refunding credit to partially satisfy the premium an issuer would otherwise have to pay for a new insurance contract covering the refunding bonds, the amount representing the refunding credit is not earned when the contract is terminated because the amounts are really "returned to the issuer" in the form of a credit. Taxpayer X further contended that despite the fact that all of the financial guaranty policies it issued during the years in issue contained a no-refund clause, Taxpayer X and the issuers should have been viewed as having modified the no-refund clause each time a refunding bond policy involving a refunding credit was purchased.

The New York State Insurance Department ("Insurance Department"), in two informal opinions analyzed the issue presented in the Taxpayer X case. The Insurance Department is responsible for supervising and regulating all insurance business in New York State. As a financial guaranty insurer, Taxpayer X was governed by the New York State Insurance Law in general and Article 69 thereof, in particular. The Insurance Department specifically stated:

1. That Taxpayer X's practice of applying amounts from the unearned premium reserve attributable to the called bond to the refunding bond is not in violation of the reserve requirements set forth in New York Ins. Law § 6903;

2. That Taxpayer X's practice of applying a "refunding credit" does not violate New York Ins. Law §§ 6905 and 2324, which govern the pricing of premiums for financial guaranty insurance; and

3. That Taxpayer X's use of commitment letters in connection with the negotiation of insurance coverage for refunding bond issues constituted a proper means of modifying the no-refund clause of the refunded bond contracts.

In effect, the Insurance Department took the position that Taxpayer X, by allowing a credit for the premium previously paid by the issuer on the original bond issue, was modifying the original financial guaranty policy entered into with the issuer by waiving the no-refund clause of the policy. This waiver, according to the Insurance Department, was documented through the commitment letters entered into between Taxpayer X and various issuers of the refunding bonds.

Based on this legal interpretation, the argument set forth in the TAM could not be sustained. Inasmuch as Taxpayer X legally modified the no-refund clause in the original policies, Taxpayer X was legally entitled under state law to return a portion of the unearned premium reserve to the issuer in the form of a credit against the premium due on the refunding bond policy. The legal interpretation provided by the Insurance Department was discussed with the National Office. Following a thorough review of the facts and law, the National Office advised that it had no objection to conceding the Taxpayer X case based on the facts developed subsequent to the issuance of the TAM.

In the instant case, [redacted] calculated the refunding credits and premiums earned in the same manner as Taxpayer X. [redacted] also modified the no-refund clause by utilizing commitment letters. Accordingly, it is our position that any proposed adjustment to [redacted]'s method of accounting for refunding credits cannot be sustained.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Should you have any questions regarding this matter, please contact Vincenza Taverna of this office at (212) 264-1595, ext. 211.

ROLAND BARRAL
Area Counsel (Financial Services: Manhattan)

By: ______________________________
VINCENZA TAVERNA
Attorney (LMSB)